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No. 132

IN THE

Supreme Court of the United States

OCTOBER TERM, 1950

SPECTOR MOTOR SERVICE, INC.,
Petitioner,

v.

CHARLES J. McLAUGHLIN, TAX COMMISSIONER,
DENNIS P. O'CONNOR, TAX COMMISSIONER,
SUBSTITUTED DEFENDANT,
Respondent.

ON CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENT

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INDEX

	PAGE
Opinion Below	1
Statutes Involved	2
Question Presented	2
Statement of Facts	2
Summary of Argument	6
Argument:	
I. The effect of the decision by the Connecticut Supreme Court of Errors	7
II. The effect of registering with the Secretary of State for the purpose of doing business in the State of Connecticut	9
III. The Spector Company does not carry its share of the Connecticut tax burden nor that of any other state	10
IV. The tax, though labeled a franchise tax, is really a tax on the use of tangible personal property and real estate in the State of Connecticut, and is constitutional	14
V. The judgment of the Circuit Court of Appeals should be sustained	18
Appendix A—Taxing Statutes	23
Appendix B—Report of 1933 Tax Commission	26
Appendix C—Intent of Tax Commission	30

CASES CITED

	PAGE
Anglo-Chilean Nitrate Sales Corp. v. Alabama, 288 U. S. 218	10
Anniston Mfg. Co. v. Davis, 301 U. S. 337	16
Blodgett v. Holden, 275 U. S. 142	17
Butler Bros. v. McColgan, 315 U. S. 501	11, 17
Central Greyhound Lines v. Mealey, 334 U. S. 653	17
Fed. Trade Comm. v. Amer. Tobacco Co., 264 U. S. 298	17
Flint v. Stone Tracy Co., 220 U. S. 107	10
General Trading Co. v. State Tax Comm., 322 U. S. 335	11, 15
Inter. Oil Pipe Line Co. v. Stone, 337 U. S. 662	14, 20
Joseph v. Carter and Weeks Co., 330 U. S. 422	15
Martin Ship Service Co. v. Los Angeles, 34 Cal. (2nd) 793	21
Matson Nav. Co. v. State Board, 297 U. S. 441	11
McGoldrick v. Berwind-White Coal Co., 309 U. S. 33	11
Memphis Natural Gas Co. v. Beeler, 315 U. S. 649	14
Memphis Natural Gas Co. v. Stone, 335 U. S. 80	17
Michigan v. Michigan Trust Co., 286 U. S. 334	10
Murdock v. Penn., 319 U. S. 105	15
Peck v. Lowe, 247 U. S. 165	14
Postal Tel. Co. v. Richmond, 249 U. S. 252	11
Postal Tel. Cable Co., v. Adams, 155 U. S. 688	15
Spector Motor Service, Inc. v. Walsh, 135 Conn. 37	7, 14
Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113	11, 18
U. S. Glue Co. v. Oak Creek, 247 U. S. 321	11
Western Live Stock v. Bureau of Revenue, 303 U. S. 250	11

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To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States:

Opinion Below and Previous Opinions

The petition for certiorari was granted from the judgment of the United States Circuit Court of Appeals (Second Circuit) dated March 29, 1950, reported in 181 Fed. (2nd) 150.

This is the second time this case has come before this Court, the previous opinion being reported in 323 U. S. 101.

The first judgment in this case was rendered by the United States District Court (Conn.) in 47 F. Supp. 671. This judgment was reversed by the Circuit Court of Appeals in 139 Fed. (2nd) 809.

After the previous opinion in this Court, an action was brought in the Connecticut courts which resulted in an opinion of the Supreme Court of Errors (Conn.) reported in 135 Conn. 37.

Later, a motion was made to dissolve the injunction issued by the United States District Court (Conn.) and this was denied (88 F. Supp. 711). The Circuit Court of Appeals reversed the District Court in its judgment of March 29, 1950.

Jurisdiction

This Court granted certiorari on October 9, 1950, by virtue of the provisions of 28 U. S. C. Sec. 1291.

Statutes Involved

The taxing statutes involved in this case are Sec. 418c, 1935 Supp. to the General Statutes of Connecticut, amended in 1937 by adding the words "or having the right to carry on" business (Sec. 255d, 1937 Supp.); Sec. 419c, 420c. These sections are reproduced in Appendix A of this brief.

Question Presented

Does Connecticut have the right to levy a corporation business tax on the petitioner, which is a Missouri corporation engaged in the motor transport business, having terminals and trucks located in Connecticut and doing a major portion of its business in Connecticut?

Facts

The Spector Motor Service, Inc. (hereinafter called Spector Company) was incorporated in June, 1933 as a Missouri corporation, having its principal office in St. Louis. It engaged in the motor carrier business by virtue of an Interstate Commerce Commission permit, hauling goods from St. Louis to New York. Recognizing the advantages of a two-way haul, the Spector Company pioneered this movement. Whereas formerly trucks returned from the East empty or laid over for a period of time, the two-way haul insured a return load as quickly as possible. To accomplish this, terminals were established in the East whereby less than truckload deliveries were consolidated,

sorted and arranged so that a full truckload delivery was made on the return trip to the West.

Terminals were established in New Britain, Connecticut (1933) and in Bridgeport, Connecticut (1934-5). These were leased terminals, operated under a lease of three to five years and on a month to month lease, respectively. Rent of $300 to $350 and $325 per month was respectively paid. Other terminals were established in New York, N. Y., Chicago, Ill., Boston, Springfield and Worcester, Mass., Saylesville, R. I., Newark, N. J. and St. Louis, Mo. The terminals other than those in Connecticut and New York, which were leased terminals and used solely by the Spector Company, are agency terminals, i.e., the terminal facilities of other carriers were utilized.

Upon the opening of the terminal in New Britain in 1933, the Spector Company registered with the Secretary of the State of Connecticut as a foreign corporation doing business in the State of Connecticut and paid the statutory fee, and has continued to do so each year since that time.

The terminals were and are operated as points of origin and destination of freight. Shipments picked up at Connecticut factories by either Spector Company trucks or owner-operator trucks hired by the Spector Company, carry the goods to the terminals where the goods are sorted, consolidated, loaded onto trucks and dispatched out of the State. The terminals also were used as points of unloading and distribution. Five trucks owned by the Spector Company, registered with Connecticut license plates, were used as pick-up trucks in the State of Connecticut, never leaving the confines of the State.

Seventeen employees operated the New Britain terminal and handled the freight originating at and destined to that point. The staff included bookkeepers, a general manager and a sales solicitor. Ten employees operated the Bridgeport terminal. Accounts receivable for all New England, fifty percent

of which were prepaid, were collected at the New Britain terminal. The New Britain employees' payroll amounted to $1,200 per week. They were paid by draft on a Chicago bank, which drafts were drawn, issued and delivered at New Britain. A bank account was kept at Bridgeport, Connecticut, for the deposit of collections made by drivers. Some incidental bills were paid by the New Britain office. Local personal property taxes were paid in New Britain on property valued at $1,500 by the Spector Company. The Bridgeport equipment was valued by the Spector Company at $500.

The Spector Company operated a fleet of about one hundred fifty trucks, almost all of which are owned by The Wallace Transport Company, an Illinois corporation, which leased them to the Spector Company. The Spector Company made application to and received tires from the New Britain branch of the Office of Price Administration. Contracts were also made with local truckers to pick up goods at Connecticut factories and deliver the same to the Connecticut terminals.

From 1936 through 1940 the following percentage and amount of the gross business of the Spector Company originated in, was attributable to, and was derived from the State of Connecticut:

1936—47% or $111,709.97 of a total business of $233,787.78.

1937—37.86% or $166,610.06 of a total business of $440,025.92.

1938 (1st 5 mos.)—47% or $150,296.95 of a total business of $318,786.85.

1938 (7 mos.)—50% plus or $218,471.73 of a total business of $432,087.39.

1939—42% or $505,777.47 of a total business of $1,202,210.35.

1940—34% or $587,973.59 of a total business of $1,723,510.65.

The Connecticut Corporation Tax is designated as a fran-

chise tax measured by net income for the use of tangible personal property and real estate in the State. The Tax Commissioner assessed a tax against the Spector Company on the business done by the company within the State and the income derived from the State. The United States District Court rendered judgment for the Spector Company restraining the Tax Commissioner from assessing and collecting the tax, ruling that the tax was a burden on interstate commerce. The Court found that since the Spector Company was engaged solely in interstate commerce, it consequently could not be subjected to the tax unless it could be shown that some intrastate business was done by the Company.

An appeal was taken to the Circuit Court of Appeals for the Second Circuit, which Court after hearing reversed the District Court by judgment entered January 20, 1944, and ordered judgment for the defendants on the merits, holding that the trend of decisions on state tax cases attacked under the Commerce Clause made it apparent that the Supreme Court would uphold such a tax as the instant one applied to the plaintiff, that it was intended to apply to the plaintiff, and, as so applied, not in violation of the state or federal constitutions. The Court stressed the fairness of the method of allocation of the tax to income derived from business originating within the state and concluded that the Supreme Court would look beyond the formal classification of the tax as one upon the privilege of doing an interstate business, and upheld it as a fair charge upon the taxpayer for the state's services to it. 139 F. 2nd 809.

The Supreme Court granted certiorari, 322 U. S. 720, and by mandate dated January 7, 1945, vacated the judgment of the Circuit Court of Appeals and remanded the cause to the District Court with directions to retain the bill pending the determination of proceedings to be brought in the state court in conformity with the opinion of the Supreme Court dated December 4, 1944, holding that the federal courts should defer

determination of the constitutionality of the state tax until the state courts had an opportunity to determine the application and constitutionality of the act as applied to the plaintiff under local law. 323 U. S. 101.

Following the decision of the United States Supreme Court, an action for declaratory judgment was brought in the Superior Court for Hartford County, Connecticut, dated December 21, 1944, from the judgment of which Court (August 14, 1947) an appeal was taken to the Supreme Court of Errors of the State of Connecticut.

The Supreme Court of Errors, by its decision undertook to answer the questions as to the interpretation of the Act posed by the opinion of the Supreme Court of the United States in this action. 135 Conn. 37.

Thereafter, on February 11, 1949, the defendant moved in the District Court for dissolution of the injunction entered in said Court on December 21, 1942. It was decided by the parties that no further evidence would be submitted.

The District Court denied the motion on November 1, 1949 and on appeal, the Circuit Court reversed the District Court on March 29, 1950 and ordered the injunction dissolved.

SUMMARY OF ARGUMENT

I. The effect of the decision by the Connecticut Supreme Court of Errors.

II. The effect of registering with the Secretary of State for the purpose of doing business in the State of Connecticut.

III. The Spector Company does not carry its share of the Connecticut tax burden nor that of any other state.

IV. The tax, though labeled a franchise tax, is really a tax on the use of tangible personal property and real estate in the State of Connecticut, and is constitutional.

V. The judgment of the Circuit Court of Appeals should be sustained.

ARGUMENT

I

The effect of the decision by the Connecticut Supreme Court of Errors.

When this case was before the United States Supreme Court on the previous occasion (323 U. S. 101), the cause was remanded to the District Court with directions to retain the bill pending determination of proceedings to be brought in the State courts, for the purpose of testing the validity of the tax laws involved under the Connecticut Constitution, and to decide from what aspect of interstate business Connecticut seeks an exaction. An action for a declaratory judgment was thereafter brought in the Connecticut courts.

Spector Motor Service, Inc. v. *Walsh*, 135 Conn. 37.

The following conclusions were reached in that opinion, viz:

(a) The business of The Spector Company was within the purview of the Connecticut Business Tax Act in question in this case. (Page 50 of the opinion).

(b) It was the intent of the legislature, in passing the taxing statutes here in question, to levy an excise tax on both domestic and foreign corporations which is based on the amount of business attributed to their activities in Connecticut. (Page 55).

(c) The tax commissions (1911, 1933), which considered and recommended the passage of these tax laws, were fully aware of the constitutional prohibition to tax directly the receipts from interstate commerce. They sought to overcome this obstacle by limiting the tax to a reasonable percentage of the proportionate amount of business attributable to the activities of the taxpayer in Connecticut. The use by the legislature of net income instead of gross income (as recommended by the

tax commission) as a base, did not change the essential characteristics of this tax. (Page 53).

(d) As regards a corporation doing business both within and without the State, the intention was, by the use of the allocation fraction formula, to measure the tax by determining as fairly as possible the volume of its business which originates in Connecticut. (Page 57).

(e) The tax in question was intended to impose upon each corporation a share of the general tax burden as nearly as possible equivalent to that borne by other wealth in the State of Connecticut. (Page 56).

(f) The taxing statutes, as they apply to The Spector Company, do not violate any provisions of the Connecticut Constitution. (Page 68).

(g) The Tax Commissioner followed the correct procedure in assessing the taxes against The Spector Company. (Page 70).

(h) The taxing statutes apply to The Spector Company because its income is derived from the use of personal property and real estate in the State of Connecticut. (Page 70).

(i) The Tax Commissioner's action in permitting a deduction of only 60% of the sums paid by The Spector Company for the hire of its trucks as expenses not included in "rent," was correct in the absence of convincing evidence that this was unfair. (Page 69).

(j) No decision is rendered whether the acts in question violate the federal constitution because that matter is still before the federal courts for decision. (Page 70).

These conclusions are now binding on the parties and the question is narrowed as to whether Connecticut is attempting to impose an undue burden on interstate commerce through the medium of a corporation business tax act.

II

The effect of registering with the Secretary of State for the purpose of doing business in the State of Connecticut.

Connecticut seeks to collect taxes for the years ending 1936 to 1940, inclusive. The 1933 act (Sec. 418c) governs the validity of the assessment for the years ending May 31, 1936 ($618.36) and May 31, 1937 ($937.98). See par. 12 complaint rec. reprint 4.

As of June 11, 1937 this Act was amended to include a tax not only on corporations carrying on business in the State, but also on corporations "having the right to carry on business in this state." (Sec. 255d, 1937 Supp. to General Statutes). All the assessments subsequent to May 31, 1937 which are involved in this case are governed by the amended statute.

It is admitted that The Spector Company qualified to do business in the State of Connecticut on June 11, 1934 by filing the necessary papers with the Secretary of State. (Plaintiff's Exhibit I).

The plaintiff attempts to avoid the effect of this statute (Sec. 255d) by claiming that the application to do business was only filed to satisfy the lessor of property which it leased in Connecticut, and for no other purpose; that it could not do business in the State without a permit from the State Public Utilities Commission, which it purposely never obtained; and that in fact, it never did an intrastate business.

This Court has held that the qualification of a corporation by the Secretary of State, to do business (a right solely within the province of the State to grant) is sufficient to sustain a franchise tax even though no intrastate business was actually transacted.

Michigan v. *Michigan Trust Co.*, 286 U. S. 334.
Flint v. *Stone Tracy Company*, 220 U. S. 107.

See also dissenting opinion of Cardozo, J., Brandeis, J., Stone, J., in the case of

Anglo-Chilean Nitrate Sales Corp. v. *Alabama*, 288 U. S. 218.

The necessity of a permit from the Public Utilities Commission stems from the police power of the State (Chap. 265, Rev. 1949) and could have been obtained at any time by the plaintiff. The plaintiff was very desirous of establishing a terminal in New Britain, Connecticut. The location sought could not be obtained without the qualification to do business. Such a qualification enabled the petitioner to use the courts of the State of Connecticut to sue and be sued. (Sec. 5246 to 5256, Rev. 1949). It sought these rights, not as rights belonging to interstate commerce, but as rights common to all corporations carrying on both intrastate and interstate business. Why should it not pay its fair share of tax for the aid given it by Connecticut to establish its terminal in New Britain?

The fact that petitioner had to also comply with a police regulation does not detract from the valuable rights obtained by the qualification to do business, any more than the duty of plaintiff to obey the traffic laws or excessive loading laws of the State.

It is undeniable that the plaintiff did use tangible personal property and real estate in this State, and because it qualified to do business in the State the assessments after May 31, 1937 should be sustained.

III

The Spector Company does not carry its share of the Connecticut tax burden nor that of any other State.

The result intended to be accomplished by the Commerce

Clause of the Federal Constitution is to prohibit the various states of the Union from placing an unwarranted burden, including a tax burden, on the right to carry on trade or business between one state and another. If the tax (burden) is not directed against interstate commerce as such, and if it is not discriminatory, and is fairly levied against all in the same class, this Court has on many occasions said that the tax is constitutional. Those engaged in interstate commerce must pay their just share of the tax burden of the State.

Western Live Stock v. *Bureau of Revenue*, 303 U. S. 250.
Postal Telegraph Co. v. *Richmond*, 249 U. S. 252.
McGoldrick v. *Berwind-White Coal Co.*, 309 U. S. 33.
General Trading Co. v. *State Tax Comm.*, 322 U. S. 335.
Underwood Typewriter Co. v. *Chamberlain*, 254 U. S. 113.
Butler Bros. v. *McColgan*, 315 U. S. 501.
Matson Nav. Co. v. *State Board*, 297 U. S. 441.
U. S. Glue Co. v. *Oak Creek*, 247 U. S. 321.

Connecticut is not attempting to levy a tax on The Spector Company because it is engaging in interstate commerce. The tax is levied because the plaintiff saw fit to make use of tangible personal property and real estate in Connecticut. If the plaintiff did not establish terminals in Connecticut and use its pickup trucks and its scales and other equipment located in the terminals, for the purpose of obtaining business in this State, the tax would not apply to it. There is no tax on the right of The Spector Company to travel through the State with its trucks and trailers.

The Commerce Clause should not be used by a company as a loophole to avoid its fair burden of a tax in a State where it is carrying on an extensive business. The record shows that the plaintiff derived a very large part of its business in Con-

necticut through the use of its terminals. In the statement of facts, supra, we point out that during the years in question, the amount of its business originating in Connecticut was as follows:

	Total Receipts
47% in 1936 out of	$ 233,787.78
37.86% in 1937 out of	440,025.92
About 48.5% in 1938 out of	750,874.24
42% in 1939 out of	1,202,210.35
34% in 1940 out of	1,723,510.65

Through the simple device of creating The Wallace Transport Company under the laws of the State of Illinois, The Spector Company, during these years, paid only the following annual corporation taxes to the various states in which it operated, viz:

$75 to Illinois
$75 to Missouri
$50 to Connecticut

Occupancy tax to New York, the amount of which is not stated in the record, but which was evidently nominal in character. (Rec. reprint 65, 66)

Of course the plaintiff had to pay various state unemployment taxes (which are not corporation taxes) and a net income tax to Missouri, but by using The Wallace Transport Company as a lessor of its trucks, the plaintiff was able to deduct rent payments for this equipment from its income, thus showing nominal net profits from its operations. In that way income taxes to Missouri were reduced to the vanishing point.

The Wallace Transport Company was evidently solely a tax saving device because, by incorporating this company in Illinois, a great saving was effected in the tax on registration plates. They were able to use the T plates at a cost of $36. per truck per year as against $250. per year if this corporation was not organized and plaintiff had to use the X plates. On the

basis of 150 trucks used in its operations, a saving of $32,100. per year in registration fees alone was effected. (Rec. reprint 31)

We do not deny the right of the plaintiff to use all legitimate means to save taxes, but when the plaintiff claims that Connecticut is attempting to put it out of business by levying a terribly harsh tax on its right to engage in interstate commerce, then we say that this company is paying practically no taxes anywhere for its right to engage in business in a corporate capacity; that the railroads with whom plaintiff competes pay their fair share of the tax burdens of the states through which they pass; that the Commerce Clause was not intended to shield the plaintiff from carrying its fair share of such tax burden; that the use of pickup trucks and terminals in Connecticut distinguishes the operations of this company from those in other states through which its trucks merely pass; and that the plaintiff has shown no equity in its favor.

That the tax was reasonable, fair and not discriminatory cannot be disputed in view of the conclusions reached on these subjects by the Connecticut Supreme Court of Errors.

Also, Exhibit 14 shows how small the Connecticut tax is (not including penalties and interest) compared to the business obtained in the State through the use of the pickup trucks and terminals, viz:

Period	Gross Business Originating in Connecticut	Amount of Tax
Year ending May 31, 1936	$ 111,709.97	618.36
Year ending May 31, 1937	166,610.06	937.98
Jan. 1—May 31, 1938	150,296.95	1,113.56
June 1—Dec. 31, 1938	218,471.73	698.94
Year ending Dec. 31, 1939	505,777.47	1,407.85
Year ending Dec. 31, 1940	587,973.59	1,306.08
Totals	$1,740,839.77	$ 6,122.77

The payment of these inconsequential corporation taxes, when plaintiff is paying practically no corporation taxes elsewhere, can hardly be claimed to be arbitrary or confiscatory.

IV

The tax, though labeled a franchise tax, is really a tax on the use of tangible personal property and real estate in the State of Connecticut, and is constitutional.

The difficulty in this case, we believe, arises from the fact that the U. S. District Court and the plaintiff have incorrectly labeled the taxes here involved "franchise taxes". Since such a tax is levied for the privilege of doing business in a state, and The Spector Company did no business in the State of Connecticut, except an interstate business which was beyond the powers of the State to allow or not allow, it is argued that the tax is a direct burden on interstate commerce and therefore unconstitutional. The tax, however, is not solely a "franchise tax". That is only part of the story. It is true that the Conecticut Supreme Court of Errors said it was a "franchise tax" but that Court also said that the tax applies to The Spector Company because its income is derived from the use of tangible personal property and real estate in the State of Connecticut.

Spector Motor Service, Inc. v. *Walsh*, 135 Conn. 37, 70.

We claim that it is of the utmost importance in this case to consider the real nature of this tax and not the label which the legislature may have put on it. This Court has stated that the name of the tax is not important; it is the substance of the tax which controls it constitutionality.

Interstate Oil Pipe Line Co. v. *Stone*, 337 U. S. 662.
Memphis Natural Gas v. *Beeler*, 315 U. S. 649.
Peck v. Lowe, 247 U. S. 165.

The plaintiff in the Court below admitted that interstate

commerce may be taxed by a state on property physically located within the state although used exclusively in interstate commerce.

Postal Tel. Cable Co. v. *Adams*, 155 U. S. 688.

Plaintiff also admitted that a use and sales tax on such property, and a non-discriminatory income tax, were constitutional.

General Trading Co. v. *Tax Comm.*, 322 U. S. 335.
Joseph v. *Carter & Weeks Co.*, 330 U. S. 422.
Murdock v. *Penn.*, 319 U. S. 105, 115.

The Connecticut Special Tax Commission of 1933, which recommended the passage of the tax laws here involved, called it a "net earnings tax" and considered its constitutionality (See Appendix B, this brief). The legislature called it a "franchise tax" though no change was made in the basic principle of the tax as recommended by the commission. It is also known as a "corporation business tax". The taxing statute, however, under which the plaintiff was taxed, clearly states that it only applies to net income "when derived from the manufacture, sale or use of tangible personal or real property" located in Connecticut. (Sec. 420c, (3) (b), 1935 Supp. to General Statutes)

The essential characteristic of this tax as distinguished from a bare "franchise tax" is that it applies to The Spector Company, not only because it is a tax on its privilege to carry on business in Connecticut as a corporation, but also because it is using tangible personal property (pickup trucks, scales, hand trucks, platforms, etc.) and real estate (leased terminals) which are located or have a situs in Connecticut. This State is constantly guarding such property and giving it various types of protection. This property is not moving through the State in interstate commerce. It has come to rest and has acquired a permanent situs in this State. To tax the use of such property is an indirect tax on interstate commerce, which the settled law of this Court, by decisions too numerous to mention, allows a State to do.

It is true that, instead of levying an ad valorem tax on the use of such property, Connecticut has devised an ingenious scheme to tax the use of such property by measuring (by the use of three factors) the proportionate amount of taxpayer's business which the use of such property has created, and then levying a tax (here 2%) on such proportionate amount. We do not understand the plaintiff to claim that the allocation fraction works an injustice. The claim is made that the statute, in refusing a deduction of rent and interest from net income, works an undue hardship on the plaintiff. That claim is understandable when you consider that The Spector Company has divested itself of practically all income by paying a huge sum each year to The Wallace Transport Company as rent for its trucks. However, the reasons why rent and interest were not allowed as deductions are set forth in this brief later in Appendix C, and we claim they are cogent reasons and that the refusal of Connecticut to allow these deductions does not make the law arbitrary or unreasonable. The Connecticut Supreme Court of Errors found the non-allowance of these items to be reasonable and the parties should be bound by that decision. Furthermore, the Tax Commissioner did allow as a deduction 60% of the rent paid by The Spector Company as the cost of operating the trucks, and the Connecticut Supreme Court of Errors said that was correct as far as plaintiff was concerned (Page 69 of the Opinion). Certainly the plaintiff should have no objection to the disallowance of the 40% in view of the sound reasons advanced by Mr. Steege for the disallowance of this item. (Rec. reprint 75-80) The plaintiff did not offer any evidence to contradict Mr. Steege except that the plaintiff's trucks are heavier than the trucks upon which the 40% estimate was based and the tires wore out faster. We claim that such evidence is rather nebulous and not sufficient to overcome the positive testimony of Mr. Steege.

Besides, the Court will always construe a statute so as to uphold its validity where possible.

Anniston Manufacturing Co. v. *Davis*, 301 U. S. 337

Federal Trade Comm. v. *American Tobacco Co.*, 264 U. S. 298.

Blodgett v. *Holden*, 275 U. S. 142.

One who attacks a formula of apportionment carries a distinct burden of showing by clear and cogent evidence that it results in extraterritorial values being taxed.

Butler Bros. v. *McColgan*, 315 U. S. 501.

The plaintiff also claims that if this tax is repeated by the other states along its routes, it would cripple interstate business. We answer this claim as follows: *First*, by the use of the allocation fraction, even if all these states levied a similar tax, the total tax would not be more than a tax of 2% on the total net income of the company, excluding rent and interest. An income tax on net income is constitutional. *Second*, this tax can constitutionally be levied only in those states where the plaintiff has the same kind of terminal facilities as it has in Connecticut, because it is the use of the terminal facilities which enables the plaintiff to obtain business in the State. The states where these terminal facilities exist are few in number. If more terminal facilities are opened in other states, then the plaintiff will do more business and can afford to pay more tax. *Third*, since no other state has levied the same kind of tax as Connecticut, it is premature to state that if they did, an unwarranted burden would be placed on interstate commerce.

We claim that the Connecticut tax cannot be repeated by another state. Our tax is based only on business activity in the State of Connecticut. If another state had a similar tax, it would only be levied on the business originating in that state, and not on the Connecticut business. Thus the same company would be taxed, but on another phase of its business, and no double taxation of the same property would result.

Memphis Natural Gas. v. *Stone*, 335 U. S. 80.
Central Greyhound Lines v. *Mealey*, 334 U. S. 653.

Where the tax is fairly apportioned it is valid even if a similar tax is repeated by other states.

V

The judgment of the Circuit Court of Appeals should be sustained.

As pointed out by the Supreme Court of Connecticut, the genesis of the law involved in this case was the 1915 Act, which was tested and approved by the Supreme Court of Connecticut and of the United States.

> *Underwood Typewriter Co.* v. *Chamberlain*, 94 Conn. 47.
> Affirmed, 254 U. S. 113.

Spector Motor Service, Inc. v. *Walsh*, 135 Conn. 37, in discussing the 1915 Act involved in the Underwood Typewriter Co. case, supra, states at page 49 of the Opinion:

> "We shall later refer at some length to the basis of that allocation, but for our present purposes it is only necessary to note that the allocation in this case *(Underwood Typewriter Co. case)* could only be made by virtue of provisions beginning, 'when derived from the manufacture, sale or use of tangible personal or real property' in this state." (Italics ours)

On page 50 of the Opinion, when discussing the 1935 Act, the Connecticut Court says:

> "It is true that provisions for the allocation of income for taxing purposes are based upon the use of real or personal property in this state. The value of the plaintiff's personal property in this state is small and no value is placed in the finding upon its leaseholds. But obviously these were the means adopted by it for the successful operation of its business in this state, and no doubt they were of material service in producing the large proportion of the plaintiff's business which is attributable to Connecticut."

It is therefore obvious that the basis of the tax here in question is exactly the same as the basis of the 1915 tax act, viz: the use of tangible personal property or real estate in the state. The only change made in the 1935 tax act was the use of a slightly different formula in measuring the tax. Under the 1915 act the formula was

$$\frac{\text{Value of real estate and tangible personal property located in Connecticut}}{\text{Value of real estate and tangible personal property wherever located}} \times \text{Net income}$$

Under the 1935 act the formula is the average of the following three factors times the net income.

$$\left(\frac{\text{(1) Value of tangible property in Connecticut}}{\text{Value of tangible property wherever located}} + \frac{\text{(2) Wages of Connecticut employees}}{\text{Total wages of all employees}} + \frac{\text{(3) Gross receipts from Connecticut business}}{\text{Total gross receipts (excluding income from interest and dividends or capital gains)}}\right) \times \text{Net income (excluding rent and interest paid)}$$

We claim that since the basis of this tax has already been sustained by this Court in the Underwood Typewriter Co. case, supra, it is determinative of the present issue, except for the reasonableness of the new formula. Since the Connecticut Supreme Court has found it to be reasonable, and there is a valid reason for using the new formula to effect an equitable and fair dis-

tribution of the tax burden as heretofore pointed out in this brief and in Appendix B and C, and the amount of tax each year being a very small amount compared to the business done in Connecticut, the new basis of figuring the tax should not make the 1935 Act unconstitutional.

In a recent opinion of this Court, a state franchise tax is apparently sustained on business done by an interstate commerce corporation, which is not based on the use of tangible personal property or real estate located in the state.

Interstate Oil Pipe Line Co. v. *Stone*, 337 U. S. 662.

In this case, which was decided June 20, 1949, the plaintiff transported oil from its source in Mississippi to loading racks near a railroad where it was loaded on railroad cars and shipped out of the state. It was never intended to use this oil in intrastate commerce. The plaintiff also transported oil through pipe lines from its source in Mississippi directly out of the state without a stop at a railroad siding. The state did not attempt to tax this operation but did tax the business of transporting the oil to the siding on the theory that this was intrastate business and not interstate commerce. In sustaining the tax, this Court held: (1) Since all the activities upon which the tax is imposed are carried on in Mississippi, there is no due process objection to the tax; (2) The tax does not discriminate against interstate commerce in favor of competing intrastate commerce of like character; (3) Even if this business is interstate commerce, Mississippi has the power to impose this tax; (4) There is no attempt to tax interstate activity carried on outside of Mississippi; (5) No other state can repeat the tax. All of these conditions are present in the Connecticut tax act, and the act should be sustained on the basis of this decision.

In a recent well-reasoned decision, the rule is laid down that interstate commerce may be taxed by a state provided it is not called upon to pay too much or too often.

Martin Ship Service Co. v. *Los Angeles*, 34 Cal. (2nd) 793, 215 Pac. (2nd) 24.

Certainly the tax in the instant case is not a crippling exaction and, because it is apportioned, its constitutionality cannot be questioned.

We recommend for the consideration of this Court both of the learned opinions handed down by the Circuit Court of Appeals in this case. Perhaps the Circuit Court should have concluded that the tax was constitutional because it is based, as we claim, on the use of tangible personal property or real estate in the State of Connecticut. The Court felt it was more an income tax than anything else, but the following language from the opinion is very apt, viz:

> "Emphasis upon substance and a wariness as to labels is especially necessary as to a state tax termed an excise upon the privilege of doing business within the state. It is an easy slide from this to the thought that what is taxed is 'the franchise to operate in interstate commerce,' an 'exaction for a privilege no state has power to grant' as even the learned trial judge here puts it. This we venture to suggest is a pervasion of the thought behind the label. What the state wants is no exaction for interstate operations, but a fair return for what the state gives. The tax would certainly be the same under various other labels x x x." (Rec. reprint 204)

Conclusion

We respectfully claim that the judgment of the Circuit Court of Appeals be affirmed. We make no claim here that this Court has no jurisdiction to decide this matter.

Respectfully submitted,

RESPONDENT

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APPENDIX A

Section 418c, 1935 Supplement to the General Statutes:

Sec. 418c as amended by Sec. 255d, 1937 Supp. Imposition of tax. Every mutual savings bank, savings and loan association and building and loan association doing business in this state, and every other corporation or association carrying on *or having the right to carry on* business in this state which is required to report to the collector of internal revenue for the district in which such corporation or association has its principal place of business for the purpose of assessment, collection and payment of an income tax, except (1) insurance companies, (2) companies principally engaged in the transportation and communication business and subject to the gross earnings taxes under chapters 70, 71, and 72, (3) companies principally engaged in manufacturing, selling or distributing gas, electricity or water and subject to the gross earnings tax imposed under chapter 73 and (4) companies all of whose properties in this state are operated by companies subject to taxation under chapter 70, 71, 72 and 73, shall pay, annually, a tax or excise upon its franchise for the privilege of carrying on or doing business within the state, such tax to be measured by the entire net income as herein defined received by such corporation or association from business transacted within the state during the income year and to be assessed at the rate of two per cent; provided in no case shall the tax be less than the minimum tax as computed under section 421c and provided, when any company taxable under chapter 71 shall engage in any business in this state other than the carrying of passengers for hire in common carrier motor vehicles, such company shall be subject to a tax of two per cent measured by that portion of its total net income derived from such business but shall not be subject to the minimum tax computed under section 421c. Notwithstanding any other provisions of this chapter, any mutual savings bank owning, at the end of the income year, real estate acquired for debt having an assessed valuation of ten per cent or more of its total assets shall, during the calendar years 1936 and 1937, be subject to the lesser of (1) the tax imposed by this chapter

and (2) the tax imposed by chapter 68 as amended by section 355b of the 1933 supplement. (Italics added in 1937)

Section 419c, 1935 Supplement to the General Statutes:

Sec. 419c. Deductions from gross income. In arriving at net income as defined in section 417c whether or not the taxpayer is taxable under the federal corporation net income tax, there shall be deducted from gross income all items deductible under the federal corporation net income tax law, effective and in force on the last day of the income year, except (1) federal taxes on income or profits, losses of prior years, interest received from federal, state and local government securities and specific exemptions, if any such deductions shall be allowed by the federal government and (2) interest and rent paid during the income year.

Section 420c, 1935 Supplement to the General Statutes:

Sec. 420c. Allocation of net income. If the trade or business of the taxpaper shall be carried on partly without the state, the business tax shall be imposed on a base which reasonably represents the proportion of the trade or business carried on within the state. The allocation of the base of the tax measured by net income shall be made on the following basis: (1) Interest, dividends, royalties and gains from sales of intangible assets, less related expenses, when received by a company having its principal place of business within the state, shall be allocated to the state and, when received by a company having its principal place of business without the state, shall be allocated without the state; provided, when it can be clearly established that such income is received in connection with business within the state, such income shall be allocated to the state without regard to the location of the principal place of business of the taxpayer, and a similar rule shall apply to such income received in connection with business without the state; (2) gains from sales or rentals of tangible capital assets held, owned or used in connection with the trade or business of the taxpayer but not for sale or for rent in the regular course of business shall be allocated to the state if the property sold or rented be situated in the state prior to the sale or during the

rental thereof, otherwise such gains shall be allocated outside the state; (3) net income of the above classes having been separately allocated and deducted as above provided, the remainder of the net income of the taxpayer shall be allocated and apportioned as follows: (a) Such income, when derived from business other than the manufacture, sale or use of tangible personal or real property, shall be specifically allocated within and without the state under rules and regulations of the tax commissioner; (b) when derived from the manufacture, sale or use of tangible personal or real property, the portion thereof attributable to business within the state shall be determined by means of an allocation fraction to be computed as the simple arithmetical mean of three fractions. The first of these fractions shall represent that part of the average monthly fair cash value of the total tangible property held and owned by the taxpayer during the income year which is held within the state, without deduction on account of any incumbrance thereon but excluding any property the income of which is separately allocated under the foregoing provisions of this chapter. The second fraction shall represent the part of the total wages, salaries and other compensation to employees paid by the taxpayer during the income year from offices, agencies or places of business within the state, provided all such payments shall be assigned to the office, agency or place of business of the taxpayer at which the employee chiefly works or from which he is sent out or with which he is chiefly connected. The third fraction shall represent the part of the taxpayer's gross receipts from sales or other sources during the income year, excluding any income which is specifically allocated under subdivisions (1) and (2) of this section, which is assignable to offices, agencies or places of business within the state, provided such receipts shall be assigned to that office, agency or place of business at or from which the transactions giving rise thereto are chiefly originated and completed.

APPENDIX B

Report of the Connecticut Temporary Commission to Study the Tax Laws of the State and to Make Recommendations Concerning Their Revision (as provided by Special Act No. 474 of 1933 and submitted to the Governor of Connecticut on November 9, 1934).

At page 56:

SUMMARY OF STATE EXPENDITURES.

"From 75 to 80 per cent of all state expenditures from 1927-28 to 1932-33 were made for highways, charities and corrections, and education. Highways required from 33 to 47 per cent of all state expenditures; charities and corrections, from 20 to 32 per cent; and education, from 12 to 14 per cent. All other state functions, consisting of general government, protection of persons and property, development and conservation of natural resources, conservation of health and sanitation, public parks, interest, and miscellaneous, accounted for less than 25 per cent of all state expenditures."

At pages 454-456:

ALLOCATION OF NET INCOME.

"The apportionment of net income is one of the principal problems which has been faced by the tax commissioner in the administration of the law. The courts have held that apportionment of net income between the several states in which a taxpayer does business must be reasonable and equitable.[15] An arbitrary allocation fraction will be sustained in the absence of convincing evidence as to its unreasonable effect. With the 1933 amendment to the Connecticut statutes, requiring the use of separate accounting in certain cases in the allocation process, the law has been rendered much less vulnerable than it formerly was. But the danger now is that this allocation method will be demanded by taxpayers whose cost accounting systems are not sufficiently accurate to warrant its

[15] Harris Rees' Sons v. State of North Carolina, 283 U. S. 123 (1931).

use. The tax commissioner is left with only the vaguest sort of authority to pass upon the accuracy of such systems.

"When the taxpayer is unable to qualify for allocation by the separate accounting method, its income is allocated by formulas which differ from those in use in any other state. This means that the corporation doing business within and without this state is taxed upon more or less than 100 per cent of its net income in all but the most unusual cases.

A BROADER CONCEPT OF NET INCOME.

DENYING DEDUCTIONS FOR INTEREST AND RENTAL PAYMENTS.

"A business tax should not depend upon the financial organization of a corporation but rather upon the amount of business done. This is not related to the amount of capital invested by stockholders or the equity of stockholders in the assets of the corporation but rather to the amount of capital used in the business whether borrowed or contributed by stockholders. To satisfy this requirement, it is necessary to redefine net income so as to include payments and accruals to the credit of all contributors of capital—that is, rental and interest payments and accruals as well as net profits.

"It has been shown that only by such a definition of net income can the tax contributions of banks be maintained at somewhere near their former level by means of a valid tax and without substantially increasing the burden of taxes upon other corporations to which the net income or franchise tax upon national banks is tied by the provisions of section 5219 of the federal statues. But whatever the disposition by the General Assembly of our recommendations for the taxation of banks, we are convinced that the changes which we are proposing at this point in the base of the tax upon miscellaneous corporations will make for a more equitable distribution of the tax burden among these corporations and will at the same time introduce a stabilizing factor into the tax base which will be of great value in itself.

"Such modification, however, raises two questions: Will such a tax be interpreted as a burden upon interstate commerce? Will the apportionment of net earnings between states by means of arbitrary allocation fractions be held unreasonable?

"These questions may be clarified by considering the fact that the returns realized by stockholders upon their investments in a corporation are somewhat analogous to the returns realized by bondholders and lessors. It has long been recognized that stockholders' net income consists not only of fortuitous gains but also of implicit (i.e., non-contractual) interest and rent upon the investment of stockholders.

"It is generally conceded that a tax cannot be imposed upon gross receipts from interstate commerce.[15] On the other hand, it is equally well established that a net income tax can extend to profits from interstate commerce.[16] The base rather than the rate of the tax is thus established as a determining factor in questions of interpretation of the interstate commerce clause. The dicta of the court in the decisions which it has rendered on this score cannot be interpreted too literally. It is obvious that a net income tax so heavy as to encroach severely upon the normal profits of a concern may discourage interstate commerce more effectively than a moderate gross income tax. The probability is that the court would give some consideration to the burden if faced with cases involving extreme rates. But there is no probability that such rates will be imposed by this state. The only question then is the interpretation which the courts will place upon a tax base of the type under consideration.

"There is, so far as we are aware, only one decision in which the Supreme Court has ruled upon a net earnings tax. In the case of Atlantic Coast Line Railroad Co. v. Doughton (262 U. S. 413) previously cited, one of the points at issue was the burden imposed upon interstate commerce by a net income tax which,

[15] Crew Levick Co. v. Commonwealth of Pennsylvania, 245 U. S. 292 (1917).

[16] U. S. Glue Co. v. Oak Creek, 247 U. S. 321 (1918).

in the case of railroads and other public utility companies, was imposed upon a base consisting of interest and rental payments as well as net profits. The tax was upheld by the court.

"We conclude that a net earnings tax could be extended to earnings from interstate commerce because, as far as the burden imposed by it is concerned, there is no fundamental difference between such a tax and a net income tax of the ordinary type, and because such a tax has been specifically upheld by the United States Supreme Court.

"The allocation of net earnings would, we believe, constitute no obstacle to the enforcement of a net income tax framed along these lines. Gross receipts can be allocated with less difficulty than net income among the states in which business is conducted. So too can such expenses as raw materials, wages, insurance, etc. But such overhead costs as interest on indebtedness and salaries can be apportioned among the several states only upon some arbitrary basis. Hence, the fewer such deductions, the simpler becomes the allocation by a separate accounting process.

"The allocation by means of an arbitrary apportionment fraction would, of course, continue to be the common practice, but since there is no fundamental difference, as far as the geographic source of income is concerned, between income which is earned for stockholders and income which is earned for creditors and lessors, there is no reason why an apportionment fraction which will be sustained for an ordinary net income tax will not also be sustained for a net earnings tax. It may be noted that the Atlantic Coast Line case arose over a tax which was apportioned according to the ratio of mileage within and without the state of North Carolina and that the tax was not attacked upon this point." (Parenthetical matter ours).

APPENDIX C

THE INTENT OF THE SPECIAL TAX COMMISSION

The special tax commission believed that any corporation having sufficient net earnings should pay a business tax equivalent to 2% of its net earnings from Connecticut business in the event that such net earnings tax would be in excess of the minimum tax. It should be emphasized that this part of the new corporation business tax was measured by net earnings and not by net income. The net earnings of a corporation may be said to be equivalent to the sum of its net income and of the interest on borrowed money and rent on leased real estate which may have been paid by it. The special tax commission pointed out that a business tax should not depend upon the manner of the financial organization of a corporation but rather upon the amount of business done by it. The volume of business carried on by any corporation is not related to the amount of money invested by its stockholders themselves or to the equity of its stockholders in its assets, but rather in the aggregate amount of capital used in the business of that corporation whether that capital be borrowed, rented or contributed by its stockholders.

In order to be as fair and equitable as possible to all corporations a franchise tax for the privilege of carrying on business should be measured by the net earnings of each corporation. An example will illustrate. Four corporations decide to engage in the same kind of business. All have high-grade managership of equal calibre. Corporation A, however, obtains all of its capital of $1,000,000 to be used in its business from its stockholders alone. Of the amount so obtained, $500,000 is used in the purchase of land and the construction of a factory thereon; $300,000 is used in the purchase of machinery; and $200,000 in the purchase of raw material. At the end of the first year this corporation has net earnings of $100,000. This amount is also the same as its net income since it has no expenditures for interest on borrowed money or rent on real estate leased by it.

Corporation B obtains $500,000 from its stockholders, and $500,000 from the issuance of 4% bonds. Since it also has $1,000,000 with which to carry on its business, it is able to construct the same size plant, install the same type of machinery, and have the same amount of raw material as Corporation A. At the end of the first year Corporation B also has net earnings of $100,000. Since, however, it has to pay $20,000 to its bondholders, its net income amounts to only $80,000.

Corporation C obtains $500,000 paid-up capital stock from its shareholders, and instead of buying land and erecting its own factory, it decides to rent real estate having a valuation of $500,000 in which it installs machinery worth $300,000 and also has $200,000 to be used in the purchase of raw material. Corporation C also has $1,000,000 to work with, and also has net earnings at the end of the first year of $100,000. Because, however, it has to pay $50,000 rent for its leased real estate, its net income is only $50,000.

Corporation D is only able to raise $200,000 from its stockholders. It rents real estate, however, valued at $500,000 and also rents machinery placed in that factory of a value of $300,000. Since it also has a capital of $1,000,000 with which to work it is able at the end of the first year to have $100,000 in net earnings. Because, however, it has to pay $50,000 in rent on leased real estate and $30,000 in rent on rented machinery, its net income is only $20,000.

Since it is the purpose of the net earnings tax base of the present Connecticut corporation business tax act to measure that tax by the amount of business done by each corporation, all four corporations in the example illustrated will pay the same amount of tax. This is as it should be since each has the use of the same amount of capital and each carries on the identical volume of business.

In order to achieve this purpose, however, it is necessary to add to the net income which any corporation may have enjoyed, all amounts which may have been paid by it in rent for the use of leased real estate and of tangible personal property, and in interest payments on borrowed money.

It will be seen that there would have been discrimination against Corporation A in the event that it had been required to pay a corporation business tax of $2,000 while its competitor B had to pay a tax of $1,600; its competitor C, a tax of $1,000; and its competitor D, a tax of only $400.

Relative to depreciation the theory behind the present law will not warrant the non-deductibility of charge-offs for depreciation. What the special tax commission had in mind was the use of capital, not the consumption of capital.

If charge-offs were not allowed as a deduction there would be discrimination between the corporation owning real estate and the corporation renting real estate. This is due to the fact that unless the owner of the building which is leased to the corporation keeps that building entirely up to date, he will be forced to reduce his rent or to lose his tenant. In order to avoid this he will sooner or later have to spend capital which may be roughly equivalent to depreciation which has been taken on the building. If this is true, it would appear that a corporation which owns its own real estate should be given the privilege of deduction of legitimate charge-offs for depreciation.

There is a fundamental distinction between the consumption of capital and the current use of capital.

The members of and advisors to the special tax commission who went painstakingly into the economic theory behind the present law came to the conclusion that in their essence there is no fundamental distinction between interest and rent. One merges into the other.

Theoretically it should make no difference as to whether the corporation borrows $500,000 through the issuance of 4% bonds and itself erects its factory plant from such borrowed money, or whether that corporation borrows no money, but rents a factory plant having a value of $500,000. In the one case the corporation pays interest, and in the other case it pays rent. If the corporation which borrows $500,000 and puts up its own plant is not careful to set up proper reserves for depreciation to take care of the consumption of the plant erected by it, the day will inevitably arrive when its plant will be

valueless, and it will still owe $500,000. On the other hand if the landlord of the corporation which rents real estate does not take care to see that the real estate originally worth $500,000 is properly kept up in every particular and replacements are made for deterioration, depreciation and obsolescence, the corporation so renting will in time either give up its lease, or see to it that the rent paid by it is commensurate with the decreased value of the rented real estate.

In order to be fair to both corporations, although no allowance should be made for the deduction of rent or interest paid by the corporation, legitimate depreciation charge-offs in the case of a corporation owning its own plant should be allowed.

So far as is known there is no state in the union at the present time which has so painstakingly attempted to establish justice and equity as between all corporations in the levy of corporation business taxes as has Connecticut. At the same time a fair income is assured for the state.